DOW THEORY LETTERS INC.

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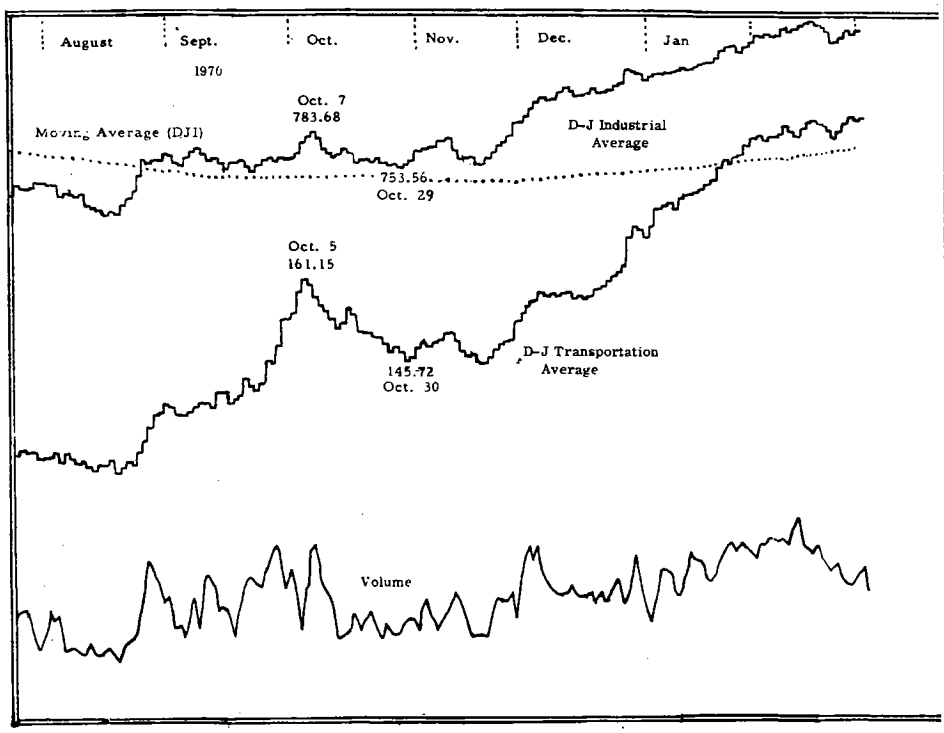
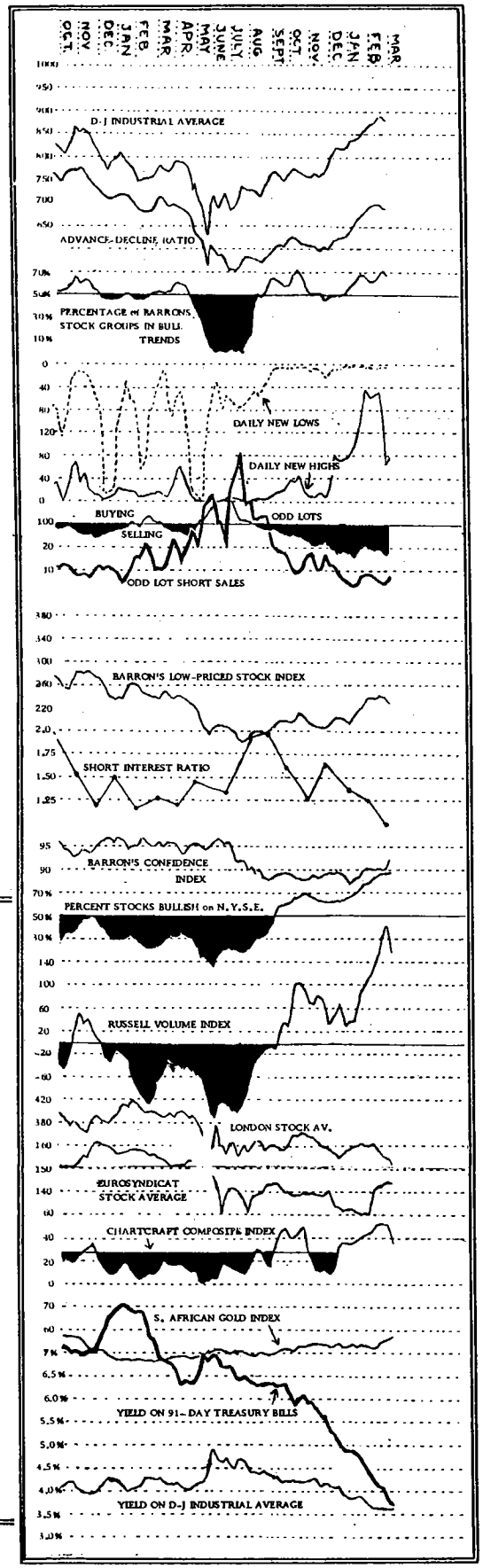
THE PICTURE: The first potential "hole" in the rising price structure of the Averages appeared between February 16 and February 22. During that brief period and following the greatest high-volume area in stock market annals, the Averages backed off. Industrials declined from 890.06 to 868.98, Transports from 195.38 to 192.24.

Subsequent to this brief and rapid decline, the market turned up again. Two days later Transports rallied to a new recovery high above the February 16 peak of 195.38. The Industrial Average provided a non-confirmation, however, and as of this writing the senior Average is still well below its own February 16 recovery peak of 890.06.

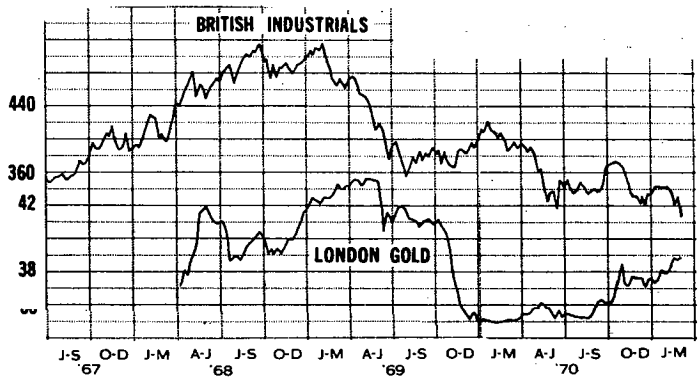
Although the Utility Average plays no part in the Dow Theory, it was noticeable that even as the Transports touched a new recovery high of February 24 the Utilities sank to 121.90, their lowest level since January 6. As stated before, the interest rate-oriented Utility Average may well have been discounting a topping out of the bond market, and the beginning of a new trend toward rising interest rates (the D-J 40-Bond Average peaked on February 12 at 71.93).

From the standpoint of Dow Theory, the Averages are providing excellent near-term "marker-points". A continued rise taking the Industrial Average to a new recovery high above the February 16 recovery peak of 890.06 would provide an "all clear" signal. In other words, the "health" of the rally will be gauged by the ability or inability of the Industrial component to confirm the Transports by bettering the 890.06 mark. Conversely, a persistent refusal by Industrials to hurdle the 890.06 point, followed by a decline in the two Averages below their February 22 lows (Industrial 868.98,





Transports 192.24) could well mean that the entire upward correction since May, 1970, was breathing its last.



As to other indicators to watch, (1) a decline in volume on any forthcoming rally would imply that the "steam" is subsiding under the "market boiler". (2) Sluggishness on the part of the advance-decline ratio (which is now occurring) would suggest that the upward momentum has been broken. (3) Listlessness on the part of the daily new high list (which is occurring) would also suggest that the main momentum is out of the rise (the peak day for new highs was 231 on January 18, on which day the Dow Industrials closed at 847.82). (4) Divergence in the Averages would indicate trouble, For instance, if Transports are declining while Industrials hurdle the 890.06 peak, the implications would not be bullish.

I want to direct attention to a few other phenomena which are "working" at this time. The first (see chart) is the decline of the British Industrial Average to the 315 area, below its 1970-71 low of 318.70. Since traditionally, movements in the British market have tended to precede movements in the U.S. market, this is a situation worth watching.

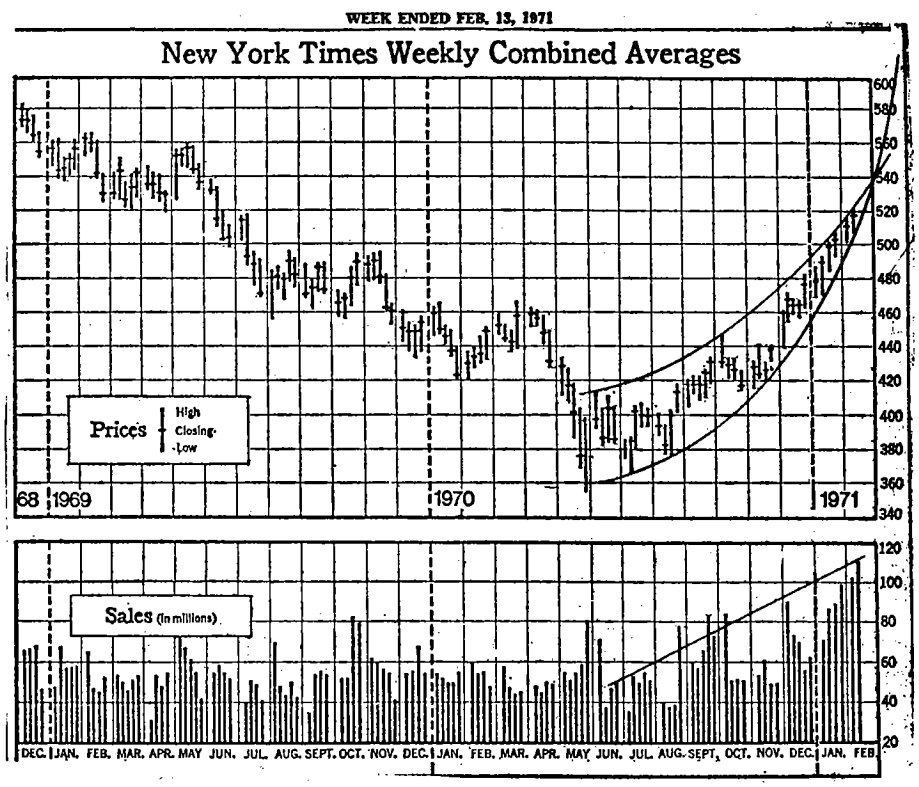
Another significant trend is the dollar price of gold (see chart) which has been inching up ever since the first quarter of 1970. The nine-month base and the steady rise since August, 1970, are a negative omen for the dollar. Remember, a rise in the dollar price of gold always represents an international "markdown" of the value of the dollar. Should the current markdown continue, there will be some "danger level" ahead, which if approached, would set off panic among dollar holders the world over. (British Industrials and gold chart courtesy of Comparitive Market Indicators, P.O. Box 1557, Bellevue, Washington 98009).

On the week ending February 28, the stock-bond ratio (see Letter 485) recorded a figure of 1.16, highest level in history. For comparison purposes, the 1929 high for the ratio was 1.09; the December 1968 peak of 1.14.

Pressure is being put on the ratio by the sharpest two-week drop in bond prices on record, and the suggestion that the big rally in the bond market is about over. The March schedule for new corporate bond issues is a record $3.5 billion, as corporations, municipalities, states and cities pour into the debt market in the face of rising expenses, decreasing incomes, and myriad financial crises.

EXTRAORDINARY FORMATION: No one man can keep up with all the thousands of facets of the stock market, let alone the economy. However, I do receive an amazing amount of help in the form of information from my subscribers. In fact, out of hand I would say that my subscribers probably represent one of the most informed and knowledgeable group of stock market students and practioners in the nation.

This week I am particularly indebted to Dr. Jesse Ehrenhaus of Cedarhurst, N.Y., for drawing my attention to the fantastic pattern of the New York Times Combined Average (weekly). Here, charted arithmetically, we see that the entire upward movement from the May, 1970, low has assumed the pattern of a perfect, rising (and converging) curve. Those who are familiar with the Edwards and Magee book classic, "Technical Analysis of Stock Trends," will note that this is a pattern often seen in low-priced issues and "cats-and-dogs" on a run-up in a very speculative market. I must confess that I have not seen this pattern before in a major average.


WEEK ENDED FEB. 13, 1971
New York Times Weekly Combined Averages
Prices High Closing Low
68 1969
1970
1971
Sales (in millions)
DEC. JAN. FEB. MAR. APR. MAY JUN. JUL. AUG. SEPT. OCT. NOV. DEC. JAN. FEB. MAR. APR. MAY JUN. JUL. AUG. SEPT. OCT. NOV. DEC. JAN. FEB.

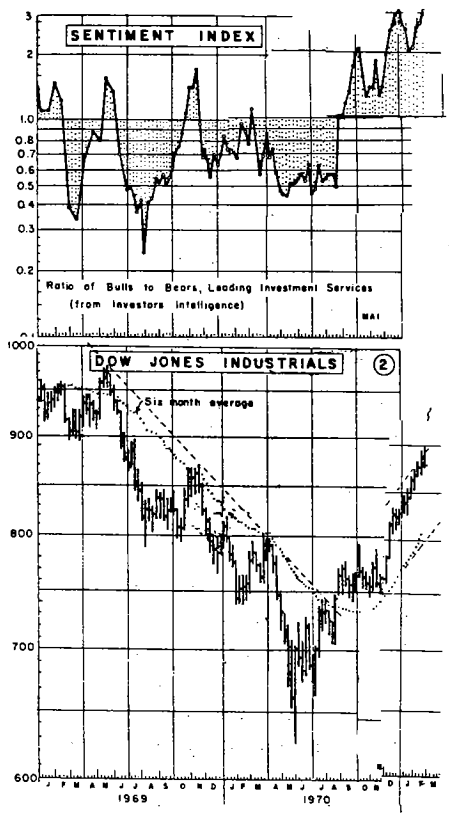
Note that the volume on the chart conforms with the speculative intensity of the movement. On the week ending February 26, the pattern was broken. It would not be unusual, now, to see a number of weeks of sideways congestion and distribution, following this extraordinary and frenzied bear market correction, before the upward momentum and speculative intensity of the market gives way, and the primary bear forces take hold again.

SENTIMENT: Although the total short interest on the N.Y.S.E. rose to 19.5 million in the latest period from 17.3 million, the big volume brought the short interest ratio down to 1.01 from the previous 1.21.

However, the more accurate Dow short interest ratio (developed by Bill Gordon of New York) turned extremely bearish. The total short interest in the 30 Dow stocks dropped from a mid-January 798 thousand to a mid-February 764 thousand, the lowest total in five months. But with volume sharply expanded, the Dow short interest ratio (see accompanying chart) sank to a very bearish .58, lowest level in ten months.

In fact, the Dow short interest ratio has been under the critical 1.0 level for six successive months, with the readings since the August, 1970 high of 1.40, as follows: September, 1970, .96, October .80, November .98, December .74, January, 1971, .77, and the latest or February .58.

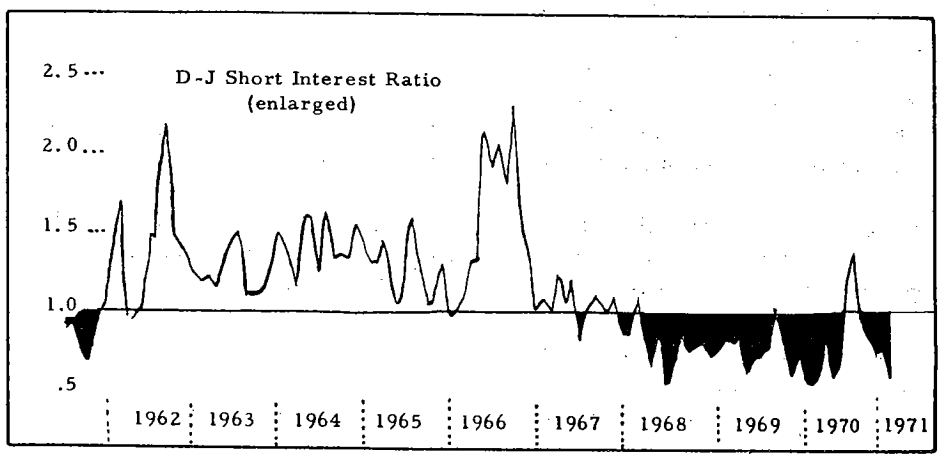
Technically, this means that in terms of volume there are far too few shorts in the 30 Dow stocks. Or to put it another way, in view of the fact that this is a rally in a primary bear market the skepticism regarding the possibility of gains on the downside is very low. In fact, the current Dow short interest ratio would signify danger even if the primary trend were bullish. But a ratio of .58 within the context of a bear market is a danger signal worth heeding.



In line with this, I have included the latest "Sentiment Index" which shows the ratio of bullish to bearish investment services (as compiled from Investors Ingelligence). The ratio is now 3.08, indicating that there are three times as many bullish as bearish services. This is the highest level seen since Inv. Intel. started their computations. I would say here that this suggests far too much bullishness on the part of the majority of services, and it is obvious that the "new bull market" thesis has gained widespread support from the services. I believe that their new-found bullishness will prove to be misplaced.

Note onthe chart, by the way, that the services tend to be most wrong at the turns. For instance, the height of bearishness among the services occurred during the May-August, 1970, period, just before the market was ready for its major upward correction. In other words, the majority of services do not stay with the major or primary trend, they tend to "follow" the market movements. When the market is in the throes of an important decline, they turn increasingly bearish. When the market embarks on a major advance they turn steadily more bullish. Thus, the primary trend of the market tends to make the investment services most wrong at the extremes of each movement.

And that is exactly why I have always advocated that my subscribers stay with the primary trend until it is exhausted. Few people "beat the market" over any considerable time on the secondary movements. The investment services are no exceptions. And the fact is that the in and out trader will not do as well as the majorityof investment services (who don't do very well at all). (Sentiment chart courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514).



GOLD AND DOLLARS: There seems to be much bewilderment about what will happen if the U.S. devalues or if we "go off" gold (demonetize). Well, nobody has all the answers to what either contingency would mean, but here are some of the possibilities as I see it.

If the U.S. decides to devalue, such a decision could come either under pressure or voluntarily. If the price of gold, for instance, climbs steadily to above $45 and then above $50, it means that the free market has already "devalued" the dollar or decided that the dollar is worth much less than the official price of 35 greenbacks for an ounce of gold. At some point, foreigners, sensing the steady decline in the dollar's value, might panic at the thought of their own huge dollar hoard steadily decreasing in value. That could precipitate a gold rush as foreign central banks stampede to grab what is left (around $10.7 billion) of the U.S. Gold reserves.

If the rush started, the U.S. would have to decide whether to pass out all our gold or to embargo gold completely. Now there is a stockpile figure (thought to be around $10 billion) which the U.S. believes is needed for defense, industrials and other purposes, so it is highly doubtful whether we would simply turn in our $10.7 billion in gold as foreign demands poured in. That means an embargo.

If we say, "No more U.S. gold sales," we are saying literally that the dollar is not convertible, and foreigners cannot exchange their dollars for gold. The question would then immediately arise, "If the dollar is not convertible into gold, what the devil is a dollar worth?" Obviously, while this question was being asked, the dollar would be "floating free" or subject to whatever the free market thought it was worth. It might be traded at a theoretical value of say 55 dollars for an ounce of gold one day, 58 dollars the next. A free floating dollar might even be quoted in terms of its relationship to a gold-backed currency such as the Swiss franc or the German mark. At any rate, in such an event, the prestige of the dollar would collapse, and foreign trade would be much more difficult for the U.S.

Foreigners would want to protect themselves against all contingencies such as more inflation or a collapse in the U.S. economy (deflation), and all sorts of hedges would be used in import or export sales to protect businessmen against violent fluctuation in the dollar. There might be a huge drop-off in U.S.-foreign trade as foreigners waited to see what would happen and whether any stability would come to the dollar.

Those are some of the possibilities in the event of demonetization. Now a second possibility is that the U.S. might unilaterally decide to devalue the dollar. Some weekend, President Nixon could announce that the dollar is now worth one-seventieth of an ounce of gold instead of one-thirty fifth. This actually would have the advantage of keeping the dollar on a set ratio in relation to gold, and it would also mean that all foreign holders of dollars would immediately find that they had lost half the value of their dollar holdings in terms of gold and other foreign currencies. As they would hardly be likely to stand for this, it is probable that all foreign currencies would also immediately be devalued in terms of gold. The net result for the U.S. would be that its gold assets would be doubled overnight. No other problems would be solved, unless tight controls were instituted and inflation halted while the new double-valued U.S. gold stock was defended.

Another possibility would be a planned, multi-lateral devaluation in which the price of gold was perhaps doubled or tripled by mutual agreement and all international currencies were adjusted so that each currency could be placed as near to its true value (in relation to gold) as possible. This would instantly mean that the world's gold reserves would be instantly doubled or tripled. Gold mines, which are currently unprofitable, would start producing again, and the world would stay on a system which retained its connection to gold. Nevertheless, this would in no way remove the danger of inflation; it would simply give the nations more time in which to solve the inflation problem.

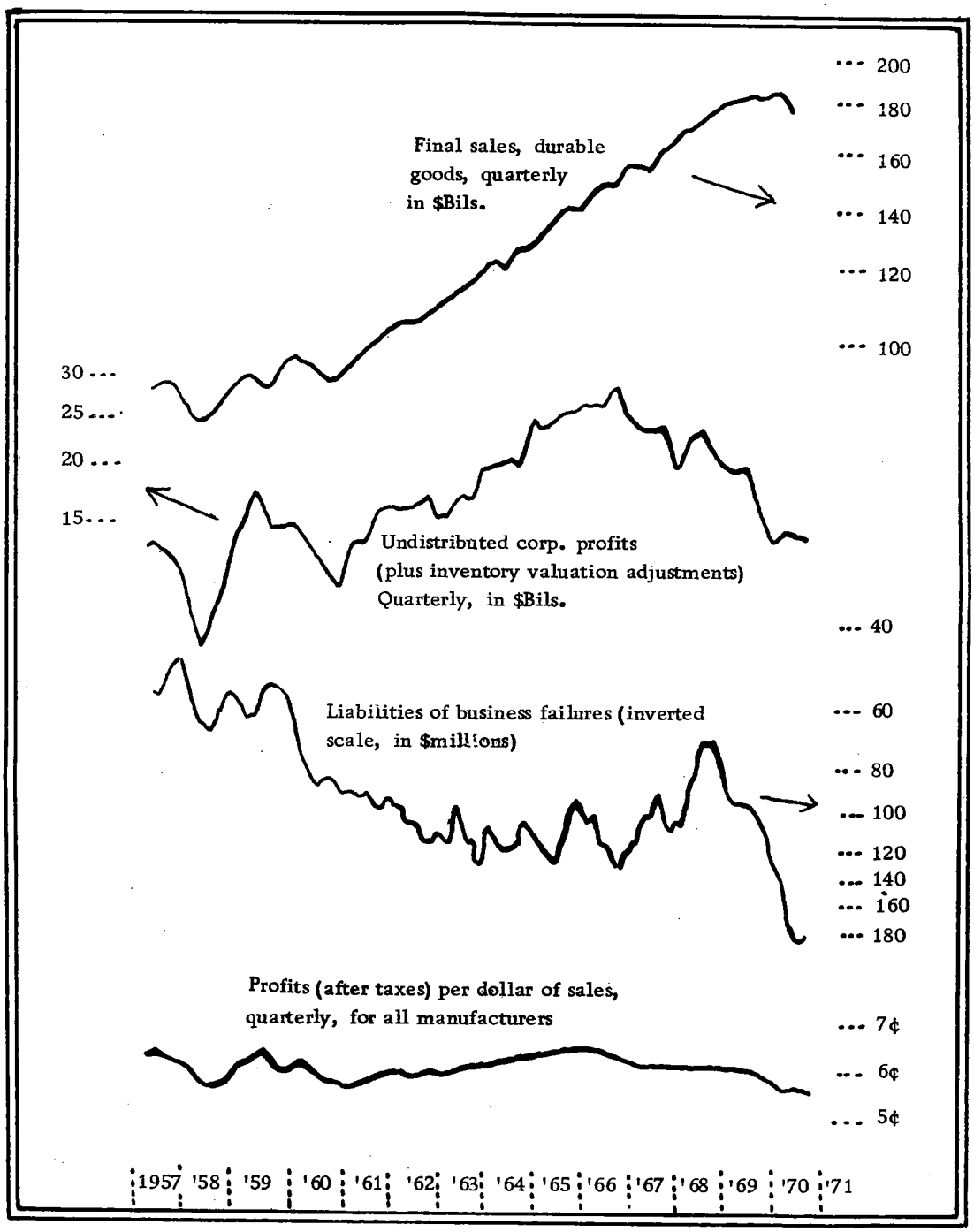
How can one hedge against these contingencies? Against a gold embargo, one might purchase foreign currencies such as Swiss francs and gold shares. However, since a gold embargo would probably bring on exchange controls, I am not too happy with purchasing foreign currencies. It might be difficult to spend foreign held currencies unless one went to the particular foreign nation and spent the money there. In the case of devaluation, the foreign nation would probably devalue also, thereby wiping out the advantages of holding the foreign currency. If the dollar is cut loose from gold, it would undoubtedly sink in value, which means that it would take more dollars to buy gold. In this case, gold shares would climb, and I feel that gold shares are therefore a reasonably good hedge against demonetization.

As far as unilateral or multi-lateral devaluation, gold shares would again provide a good hedge, whereas foreign currencies would be devalued in a day or so (or per agreement) with a devaluation of the U.S. dollar. So that again leaves us with gold shares as the only reasonably good hedge against a devaluation.

How about stamps, coins, property, homes, apartment houses, antiques, etc.? Here I would say that if the potential devaluation occurred within the framework of a primary bull market, such hedges would be legitimate. But since a devaluation or demonetization in the next year or so would occur within the context of a primary bear market, I would avoid all "things" as hedges.

The odds are that deflation would occur (following the shock of a change in the dollar price of gold), and such deflation would send the prices of all things lower. People forget that the devaluation of the 1930's occurred during a new bull market, and that the nation was then "on the floor" suffering from the worst depression and deflation in modern history. There was nowhere for prices to go but up, and that's exactly what happened.

But a devaluation today, on top of massive and prolonged inflation, within the framework or a primary bear market, would be a horse of a different color. Personally, I believe that a devaluation would still be accompanied by deflation, and the price of all things would head lower. And that is why I say that gold shares provide the only reasonable hedge to demonetization or devaluation.



ECONOMICS (See chart above): Since economics is what the stock market is constantly discounting, I thought it would be instructive to show a few rather significant trends. The accompanying chart traces four important indicators, indicators which I personally watch (not to be confused with what our Washington economists watch).

 The top index shows "final sales of durable goods", charted on a quarterly basis through the fourth quarter of 1970. Note that durable goods sales headed unabatedly upward since 1961. But since the last quarter of 1969 durable goods sales have faltered, and the latest figure shows durable goods sales back to the 1968 level.

Now durable goods sales are what make booms and recessions. Since World War II, no major period of economic expansion has been ushered in without a durable goods boom. But with factories currently at 72% of capacity and with consumers reluctant, so far, to part with their money, I would not count on a durable goods boom during the several years ahead. At any rate, the chart shows that the great boom in durable goods which began in 1961 has been interrupted. And that's all we know at this time.

The second index is very important, for it tends to show corporate liquidity or the changing net worth of all corporations (adjusted for changes in the value of the inventory which they hold). The latest reporting period is the third quarter of 1970, and we we can see here, "undistributed corporate profits" (or the amount of money which corporations retain after dividend distributions) have been in a downtrend since the last quarter of 1966, and the index is now near the low.

In order to increase liquidity, corporations must either increase profits or cut dividends. In other words, to increase profits and liquidity, corporations must cut expenses, and that is one of the reasons we see a lot of firing these days — and very little hiring. It is also the reason why we see prices going up. All of this is being done in an attempt to increase profits (or cut losses). And of course, rising wages intensify the problem, since wage boosts cut into profits unless volume can be increased (which it is not) or unless prices can be raised (which is now happening).

The third index is the grim reaper. It measures the cost of failure, and it is the "total dollar amount of bankruptcies" (scale inverted) on a six-month moving average. Currently, the bankruptcy index has plunged below the $180 million mark, and this is the highest level with which anybody in this generation has had to deal with. What more can you say about this index other than it is a measure of the level of financial mess. The level is growing.

The final index is well worth studying. It gauges the percentage of corporate profits per dollar of sales after taxes. As you can see on the chart, the high level of the first quarter of 1966 was almost 6¢ per every dollar of sales. Since then, profitability has been decreasing. The latest figure we have is for the third quarter of 1970, which shows a figure of 4.1¢ profit for each dollar of sales. In contrast, the figure for a year earlier was 5¢.

Now this is a very serious state of affairs. For with the profit take for each dollar of sales dropping and now very low, the only thing which will sustain business is increasing sales (to make up for lost profitability). But there is an ominous leverage factor here. For if a corporation earns say $4.1 million profit on $100 million sales, it can push up its total profit by boosting sales. As every businessman knows, raising one's sales is usually a boon, since you can usually do much more business with the same amount of fixed expenses. In other words, it is often efficient and profitable to increase sales since many expenses are fixed and do not increase with those increases in sales.

However, if profitability is low, as it now is, and sales decrease, you have a gathering problem. For again many expenses are fixed, but dropping volume makes those fixed expenses loom larger and larger. Therefore, with total corporate profits now only 4.1¢ per dollar of sales, a volume drop-off would be very serious indeed. That is why our top index, durable goods sales, is so important. And it is particularly important in view of our bottom line, which indicates that corporations are in no shape to face a decline in sales. So much for economics, as I see it, during this primary bear market, so far.

INFORMATION: Following are a few sources and services worth investigating.
(1) Weekly Bond Buyers, the bible of the bond market. Loaded with money and bond information. A weekly at $96 per year from 77 Water St., N.Y., N.Y. 10005.

(2) International Monetary Issues, P.O.B. 1313, Haifa, Israel (believe it or not). About $24 per year (36 issues), all sorts of very serious info and debates about international monetary affairs and gold and economics.

(3) U.S. Financial Data, free from the Federal Reserve Bank of St. Louis, Mo. All kinds of excellent charts on what's happening to our money, presented in a very readable form.

(4) Money & Credit Reports by my friend, Irv Weiss at 70 Wall St., N.Y.C. 10005. Very original opinions by one of the few original thinkers around ($48 per year for 24 issues).

Oh yes, in answer to numerous inquiries, I survived the recent Southern California earthquake.